

Diversified INVESTMENT STRATEGIES

Level 8, Tower II, 55-65 Shortland Street, P.O. Box 105142, Auckland, New Zealand. Tel: 09 366 7380 Fax: 09 366 7381.

DIVERSIFIED'S VIEW

March, 2008

"... try not to own what others own...." Economist, Andrew Hunt at Tyndall Briefing, 11/03/08, noting good and bad managers suffer in a deep downturn.

Abstract

- Despite the financial market reversals most recently, investors can still have gains for the year. (Investors pursuing *Diversified's* 'Balanced' model strategies, gained +2% to +4.5% for the year to February 2008).
- Elsewhere, and sadly, it is often supposedly 'risk averse' Kiwi retail investors, who have been damaged most. Debenture issuers and 'structured credit product' purveyors misgauged risk badly. (Losses are permanent and more severe than marketers have yet confessed).
- **Disclosure:** *Diversified's* model portfolios were caught by the failure of *Absolute Capital's Yield Strategies Fund* in July 2007. By design, the allocation to it was only 5/18ths that to Gold and gold-producer's shares, which advanced concurrently – that's diversification at work.
- Our economic research places us in the more optimistic camp. While growth may be soggy in the Developed World, we anticipate more robust conditions to persist among Emerging Markets.
- Fortuitously the Developed World's financial misjudgements occurred in a global context of very robust economic growth, and with Central Banks having very good scope to ease.
- It is now apparent that risk was woefully under-estimated by experts engineering a wide range of leverage - housing, corporate loans, MBO's, geared funds, private equity and swaps. But beyond Bear Stearns, most of the originators are still in place, intent on masking damage and wishing the good ol' days back. Braying for bail-out seems poor substitute for catharsis. The Credit Crunch has further to plumb, and real change will be required.
- Equities by contrast should bottom sooner, and may already be near their nadir.
- The fiscal and monetary largesse demanded by Wall St ('socialism for the rich?'), will result in higher inflation over the medium and longer-term.
- Notwithstanding *Diversified's* conviction an historic and powerful global economic expansion remains intact, we acknowledge risks have risen. Model portfolios had been partially de-risked before the current downturn; by divesting the dedicated allocation to high-beta resources, and by embracing defensive-capable Equity management styles.
- The prognosis for NZ's economy is less comforting. Local mandates have generally been extended to 'Australasian' over recent years. Fundamentals now favour the larger economy.

Norman W. Stacey (n.stacey@diversified.co.nz)

An Adviser Disclosure Statement is available on request and without charge, or may be accessed via our website.

DIVERSIFIED INVESTMENT STRATEGIES LIMITED

Website: www.diversified.co.nz

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New Zealand – Stagflation

stag·fla·tion [*stag-fley-shuhn*]-*noun*: An inflationary period accompanied by rising unemployment and lack of growth in consumer demand and business activity. [Dictionary.com].

NZ's adequate but unspectacular growth of 2007 is fading as fast as summer. *Diversified* earlier forecast of stagflation has been leap-frogged more recently, with congenital boosters as prominent as Michael Cullen PhD, talking of 'Recession'. Even economically erudite souls (e.g. *ANZ Market Focus* of 11th Feb., below), are revising the intensity of the slow-down ahead.

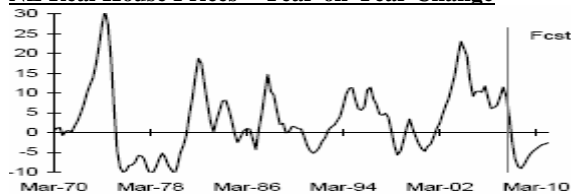
Economic Forecasts

	March 2008	Dec 2008	June 2009
GDP (%y-o-y)	+2.0%	+0.4%	+1.3%
CPI (% y-o-y)	+3.5%	+3.2%	+2.8%
OCR	+8.25%	+7.5%	+6.75%
Unemployment	3.5%	4.0%	4.2%
Terms of Trade	8.3%	-1.3%	-3.6%

Diversified is less persuaded the OCR will be cut as early, or as severely, as ANZ believe.

Major domestic imponderables include the size, nature and onset of tax cuts, countered by the negative 'wealth effect' of a deflating house-price bubble. Distress looms as mortgage cost top 10%, accompanied by the probability of real capital losses of a similar magnitude.

NZ Real House Prices – Year-on-Year Change



Source: First NZ Capital's NZ quarterly strategy, Mar 2008

Net immigration is on the verge of turning to net emigration – a situation compounded by losing the very skills NZ most needs.

Long-term investors, and Kiwi parents, will be alarmed by NZ's productivity trends - the key to lifting *per-capita* prosperity. Labour Productivity Growth, at +2.8% p.a. prior to 2000, has tumbled to +1.1% p.a. this decade and a paltry +0.5% in the year to March 2007, while Multifactor Productivity (mostly process improvements and technological changes), slumped from +1.9% p.a. to +0.4% p.a. Such is not a 'Knowledge Wave'.

Externally, growth of NZ's major trading partners is projected to dip from +3.1% p.a. to +2.9% in 2008.

NZ is entering a below-average growth period burdened by low productivity and uncompetitive policies.

Australia – Regional diversification

Australia's economic linkage with Asia marks a sharp divergence from US policy or malaise. Building approvals ticked up from a solid rate over 2007. Unemployment dropped to 4% in February while skilled vacancies rose. Motor vehicle sales are laying rubber.

Economic growth at 3.9% p.a. may taper to a still impressive, 3.3% - 3.8% range ahead. With inflation at +3.2% in 2008 (in breach of the Reserve Bank of

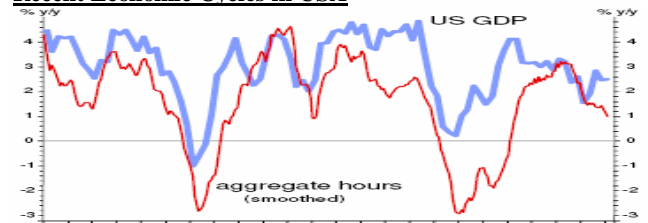
Australia's target range), a further hike to 7.5% OCR is expected this year.

Australia provides valuable diversity of politics, policies, performance and predictability, to Kiwi Investors. It is expected 'Australasian' mandates will favour the larger partner for our one-year to 18 month, tactical horizon.

International – History Rhymes

Partisan politics in USA is a little swift in taking credit, or attributing blame, for economic cycles. USA may be verging on recession this election year, but President Clinton also inherited a rebounding USA economy in 1992, and left it plunging into recession in 2000.

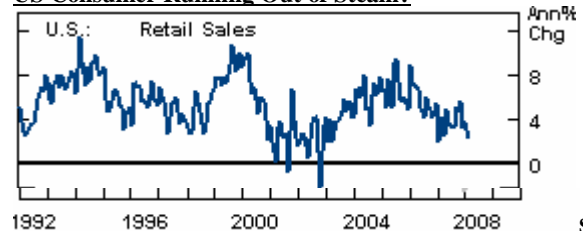
Recent Economic Cycles in USA



Source: Halkin Weekly Notes of 7th March 2008.

More pertinently for investors, USA consumerism is now convincingly waning, in the face of financial uncertainty and high fuel prices.

US Consumer Running Out of Steam?



Source: BCA Research Daily Insight, March 14th, 2008

The trend will impact trading economies, and offers a harbinger for NZ's sizeable retail sector and listings, when growth slackens here.

Uncomfortable as they may be, Wall Street's woes are not the end of civilization as we know it. *Diversified Investment Strategies Limited's* research finds the overwhelming probability being that a robust global economic expansion will prevail on an aggregate basis; and evidently so within our one-year to 18 month, tactical horizon.

Global Economic Growth

Region	2008	2009	Relative Size
USA	+1.4%	+2.3%	18.7%
Australia	+3.3%	+3.2%	1.0%
Europe	+1.9%	+2.0%	20.7%
UK	+1.7%	+1.9%	3.1%
Japan	+1.3%	+1.8%	6.0%
China	+10.2%	+9.6%	16.0%

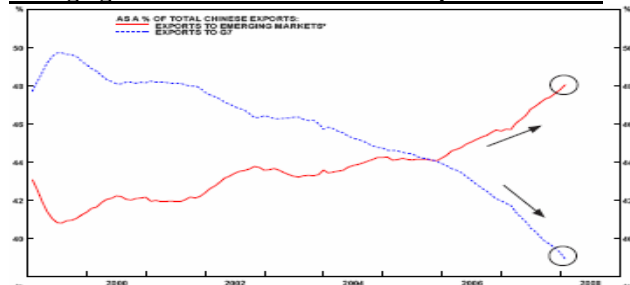
Source: Growth data from BNZ Offshore Overview, March 2008. Relative size of GDP (PPP-adjusted) from IMF data.

Investors, actuaries or fund-managers aping the Morgan Stanley Capital International (MSCI) World Index are systemically biasing their followers to low-growth areas – and arguably to higher risk.

Even amidst heightened global economic uncertainty, *Diversified* continues to find Emerging Economies prospective. Undoubtedly the First World's current

malaise will have some damping influence global trade, export jobs and consumer spending. But more important are the now dominance of intra Emerging Market trade flows, diverging, (decoupled?) domestic demands, aided by their relative insulation from the travails of western banks.

Emerging Economies' Internal vs. Developed trade Ptnrs



Source: BCA WebCast, March 2008

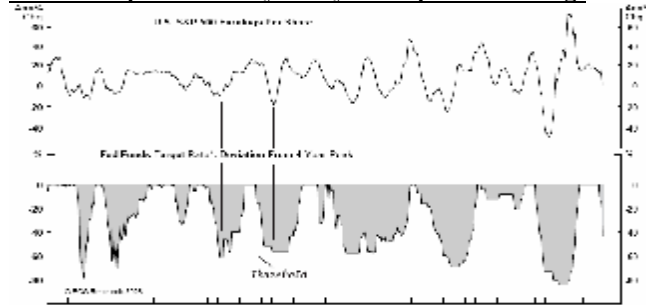
Most favoured are Hong Kong, Thailand, Malaysia, Egypt, Turkey, and the Gulf Petro-economies. India may be troubled by social unrest over soaring food costs.

Eastern Europe and South Africa are more dependent of foreign debt, and consequently vulnerable to sharply rising costs.

Public concern over the economy is intense. Institutional insolvency, delinquencies extending to prime mortgages and leverage problems extending generally, will force the USA and Europe to continue easing aggressively. **Reflation will be successful, within our tactical horizon.**

Last month's graph is repeated, depicting historic success of monetary policy.

Relationship of Monetary Policy & Corporate Earnings



Source: BCA Research, GIS Weekly, Feb 1st

Diversified fully expects prosperity will resume in the Developed World. Medium and longer-term, the consequence of the US-led, fiscal and monetary liquidity being created now, will be inflationary.

Fixed Interest – Credit correction playing out

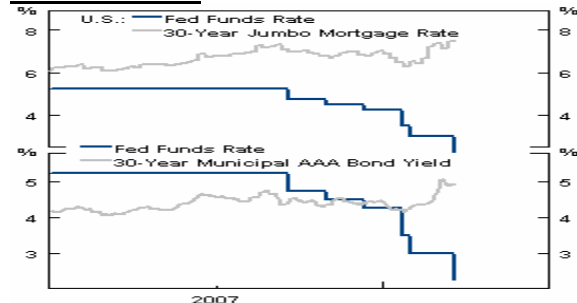
Note: ING's dreadfully named 'Diversified Yield Fund' has never lived up to its billing, for either returns or safety. The fund was closed this week, freezing investor's funds – two years to the month after *Diversified* Investment Strategies Limited issued a "Sell" instruction. Sadly, our estimate is that 40% of the ING investor's money is lost, in a still deteriorating sector.

It gives us little pleasure that exposure of the systemic miscalculation, misrating and mispricing of credit risk in the USA, is unfolding much as we predicted. The process has further to run, and immense write-offs lurk yet. Disturbingly, and beyond Bear Stearns, most of the perpetrators and originators are yet in control positions,

managing denial, camouflage and wishing to restore their lucrative habits.

US authorities are bound to reliquify banks, reeling from huge losses. The mechanism, - suddenly widening of the margin between cheap short-term money and higher long-term lending – is a privileged gift of profitability to banks.

Gift for the Banks



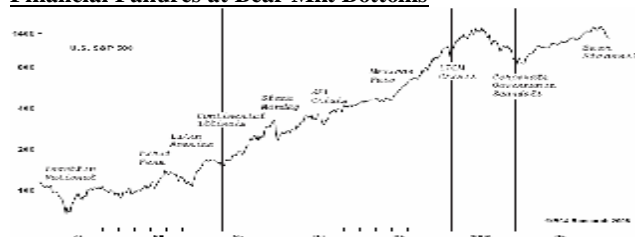
Source: BCA Research, Daily insights, March 19th, 2008. Daily Beyond legacy investments in Absolute Capital's 'structured income trap, *Diversified* model strategies prefers Cash and conventional bonds, in a generally under-weighted Fixed Interest sector.

Equities – diversification works over time, not all the time

Global sharemarket gyrations re-confirmed an almost 1:1 correlation across all regions, markets, sectors and issuers, in response to catastrophic events. Modest diversification is afforded only by style differences; 'absolute value' manager ameliorated last quarter's plunge by about 20%. *Diversified* finds comfort that 'high beta stocks' (i.e. leveraged to global growth) including Emerging Markets, Energy or Commodities, have retreated only commensurate with supposedly conservative issuers. Emotion will be more quickly reversed than fundamental weakness.

Diversified's view is that International Equities are in or near a bottoming process; one that favours our current array. With history as a guide, headlines may signal bottom, rather than cause for panic.

Financial Failures at Bear Mkt Bottoms



Source: BCA Research, Global Strategy Service. March 2008

Diversified model strategies are consistent with a major upside in sharemarkets globally, occurring within our one-year to 18-month tactical horizon. As in 2003, early gains are easiest. Long-term investors should retain quality holdings, 'seeing through' current ructions. Markets with low recent returns may make portfolios safer.

Property – Unattractive

The risk of contamination from house-price upsets, rising costs of borrowing, slowing local economy and very full prices, combine as a severe headwind for NZ investment property. From a peak allocation peaking when others were distracted by the Tech bubble, *Diversified's* model weighting has now been cut to zero.

Commodities – resilient but risky

That the price of copper has held up well - traditionally a barometer of global economic strength – gives comfort. Recent financial ructions are but a 'correction' in a continuing expansion. Resource commodity prices are now at multiples of marginal cost, and could implode before supply was constrained.

Diversified's dedicated allocation to Resources, added in mid-2003, was progressively divested as prices soared

Gold

More than a commodity, bullion is also a safe-haven, a store of wealth and a bellwether for liquidity creation. The recent spike in Bullion's price is attributable to sudden finance system woes. A sell-off of maybe 10% or 20% is conceivable, when those perceived threats recede. Concurrently, liquidity creation has become rampant. Beyond possible near-term volatility, *Diversified* believes gold is destined to attain new price highs, as a store of wealth amidst rising inflation.

Sustained higher gold prices will cause revaluation of mining company's unhedged and in-ground, proven reserves. **Selected gold producer's shares may outperform bullion price in the coming phase.**

Diversified's model strategy's, 'Balanced' profile allocation has blossomed to 20% - largely as a consequence of gold's 46% price hike last quarter – and is split between gold bullion and shares in gold producing companies.

Currency – Good on the way up, but watch out!

Following-the-crowd late in a trend is seldom a rewarding investment strategy. Managers, rigid policies and retail products who hedge a diversity of offshore currencies back to NZ\$, are concentrated in 0.16% of the world's fiat currency backing, [inadvertently?] creating Currency Risk. Diversification is the least-risk investment stance, and should be the default position unless a conviction is held. Apparently some Kiwi pundits believe the NZ\$ is headed ever-upward.

Hedging to NZ\$ is nice when that risk was rewarded, but may be fraught ahead.

Australia's currency offers sounder and larger economic backing, as well as the probability of a rising OCR.

NZ\$ in terms of A\$



Source: BNZ Offshore Overview, March 2008

In addition to a conscious and deliberate strategy of diversifying portfolio currency risks, *Diversified's* model strategies have more recently favoured holding Cash positions in A\$.

Salient Rates, Indices, & Exchange Rates

Following are the February 29th, 2008 rates and selected equity market indices, relevant currencies, with their percentage gain or loss from that of three months, six months, and one year earlier. Figures are before taxation, fees or any impact from NZ currency.

ACTUAL	29/02/08	3 Months	6 Months	One year ago
Prevailing Monetary Conditions Index.	+1431	+1291	+1026	+1105
Prevailing NZ Cash Rate (90-day)	8.85% pa	8.96% pa	8.63% pa	7.79% pa
Prevailing 2011 NZ Gov't Stock Yield	7.03% pa	7.09% pa	6.71% pa	6.35% pa
Prevailing 2015 NZ Gov't Stock Yield	6.55% pa	6.44% pa	6.30% pa	
CHANGE	Value	Gain or loss since ...		
NZX NZ Gov't Stock [Bond] Index	932.13	+1.6%	+2.2%	+4.2%
NZSE 50 (Gross)	3582.72	-11.8%	-13.0%	-11.3%
NZSCI (Gross)	22622.00	-11.7%	-10.9%	-13.1%
S&P/ASX200 (Australia) *	5572.10	-14.7%	-9.2%	-4.5%
MSCI World Index (Capital)*	1455.56	-9.7%	-6.8%	-2.3%
Dow Jones (USA) *	12266.39	-7.9%	-8.2%	0.0%
NASDAQ	2271.48	-14.9%	-12.5%	-6.0%
FTSE 100 (UK) *	5965.70	-6.1%	-5.4%	-3.3%
Nikkei DJ (Japan) *	13595.25	-13.1%	-17.9%	-22.4%
Hang Seng (Hong Kong) *	24205.87	-15.5%	+0.9%	+23.7%
NZD/USD	0.80	+5.0%	+14.3%	+14.0%
NZD/AUD	0.86	-0.6%	0.0	-3.6%
NZD/JPY	86.90	-2.0%	+2.0%	-0.2%
TWI	73.10	+2.8%	+8.3%	+5.8%
Gold (US\$ / oz., troy)	966.10	+23.2%	+43.6%	+44.6%

Crude Oil (WTI, US\$/bbl)	99.55	+9.4%	+34.6%	+61.3%
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*Indices, figures and performances in respective local currencies unless otherwise stated.

NORMAN W. STACEY, INVESTMENT ANALYST – Corporate and individual Investment Adviser Disclosure Statements are available free of charge, or on our website: www.diversified.co.nz

Diversified Investment Strategies Limited is humbled and delighted with the value we have been able to add for investors over our 14 year history, including most recently. Graph following is composite of actual net returns (after fees and taxes at source, achieved by aggregate of Diversified-advised private client investors pursuing our Balanced strategy, for calendar years to December 31st 2007. Comparison is with average net returns for retail ‘balanced’ and ‘growth’ funds, as compiled by FundSource Managed Funds Performance Statistics.

